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In The

Supreme Court of the United States

No. 769

UNITED STATES OF AMERICA FOR THE USE OF DAKOTA ELECTRIC SUPPLY COMPANY, A NORTH DAKOTA CORPORATION,

Petitioner,

vs.

ST. PAUL FIRE AND MARINE INSURANCE COMPA

Respondent.

BRIEF OF RESPONDENT IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

BENEDICT DEINARD
512 Nicollet Building
Minneapolis 2, Minnesota
Attorney for Respondent

EDMUND T. MONTGOMERY
RICHARDS, MONTGOMERY, COBB & BASSFORD
1430 Rand Tower
Minneapolis 2, Minnesota
Of Counsel

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RESTATEMENT OF THE CASE

The Statement of Facts in the petition omits the portions of the record which the Court of Appeals deemed important and which are recited in detail in the opinion below with subheadings designated as (j) through (s), or pp. 16-19 in the appendix to the petition. These facts are further summarized in three numbered paragraphs of the opinion (p. 23 in the appendix).

The facts as recited in the opinion and the record establish that at a meeting arranged by the Petitioner Use Plaintiff, Dakota Electric Company, in June, 1959, Mr. Farnham, a substantial stockholder and creditor of Dakota Electric, became voting trustee of substantially all stock of John L.

Schroeder, Inc., a subcontractor of Joseph A. Bass Company (R. pp. 22, 30, 44, 49, 82). Respondent St. Paul Fire and Marine Insurance Company was surety on the Miller Act bond of the Bass Company. The Schroeder company purchased materials required for performance of this subcontract from the Petitioner. Upon his appointment as voting trustee, Mr. Farnham promptly elected himself and the auditor for Dakota Electric as two of the three directors of the Schroeder company (R. pp. 23, 50), and thereafter until bankruptcy of the Schroeder company in April, 1960, substantially all of the frequent meetings of the directors of the Schroeder company were held at the office of Petitioner in Fargo, rather than at the office of the Schroeder company in Minot (R. p. 18); the President and the Treasurer of Petitioner attended these meetings (R. pp. 32, 33, 34, 41, 45); together with the Voting Trustee they reviewed monthly reports and had available all information they requested concerning the subcontractor Schroeder company's business, and they made and participated in many management decisions for the Schroeder company (R. pp. 18, 27, 32, 33, 43, 44, 45, 50, 59, 85, 89). During the period from May, 1959, to March, 1960, $30,953.85 was paid by Bass Company to the Schroeder company on account of the subcontract in question (R. pp. 13, 64, 104), and during the same period in excess of $72,000 was paid ($88,517.70 per R. pp. 76, 77, 78, 79) by Schroeder company to the Dakota Electric Company, but nothing whatever was applied by Petitioner Dakota Electric Company on its $6,702.15 account with the Schroeder company for materials it delivered during this period to the Schroeder company for the account of the Bass contract (R. pp. 4, 5).

The Court of Appeals concluded "that the closeness of the relationship of the named parties during the vital nine-month period was such as to create an equity of the kind de-

scribed in the general rules outlined above, and that equity required the application of so much of the Bass progress payments received by Schroeder as was required for the materials supplied by Dakota to the Bass job." (Decision, Petitioner's Appendix p. 24.)

The Court of Appeals reversed the judgment of the District Court entered in Petitioner's favor and remanded for entry of appropriate findings in favor of the Respondent.

THE RESPONDENT'S POSITION

1. The decision is not in conflict with another Court of Appeals decision in the same matter.
2. The decision below does not decide an important question of federal law; it has no applicability to Miller Act claims of laborers, and would be applicable to claims of material suppliers and subcontractors only in unusual situations where the supplier or subcontractor would be found to have established a relationship with its debtor similar to the unique situation found in the decision below.
3. The decision below does not involve an important question of federal law which has not been or should be settled by this Court; the decision involves application of a well-established rule of law as established by decisions of the Court of Appeals to a situation within the scope of that rule; at least one of these decisions this Court has refused to review.
4. The decision below does not involve a state question; it is in any event in harmony with the statutory law of the state where the transaction took place, and no reason for invocation of the writ is presented by the petition.

ARGUMENT

1. The Decision of the Court Below Is Not in Conflict with Another Court of Appeals Decision on the Same Matter.

Petitioner in its brief (p. 5) asserts that "the special rule adopted by the Court of Appeals is contrary to * * * cases cited in support of such rule." Also at p. 10 there is reference to "the conflict between the Opinion of the Court of Appeals and the Opinions of the 4th, 5th, 6th and 10th Circuits concerning application of an important rule of law to an important Federal statute."

It is apparent from the opinion below that the Court of Appeals considered its decision to be in harmony with the decisions of other circuits. In the opinion below the Court of Appeals said:

> "In no Miller Act case of which we are aware have *Farnsworth*, *Beck* and *Johnson* been disavowed." (Appendix p. 25.)

and also:

> "We are impressed by what we feel is the overriding equity of the situation before us in favor of the surety and we conclude that this brings this litigation within the orbit of the Miller Act cases of *Farnsworth*, *Beck* and *Johnson*." (Petitioner's Appendix p. 23.)
>
> "And *Farnsworth* is impressive because of its reliance upon the factor of inspection of the subcontractor's books; that case seems to us to present a far less significant fact situation than the present case where Dakota's involvement with the affairs of Schroeder is more evident and striking." (Petitioner's Appendix p. 25.)

The Petitioner cites no decisions of the Court of Appeals in direct conflict with the decision below.

Koehring Company v. United States (10th Cir. 1962), 303 F.2d 468, cited in the petition, is not contrary because there were no facts found in that case which called for application of the "special rule" which the Court of Appeals applied in

the present case. In *Kochring* the court recognized the rule applied by the Court of Appeals in the decision below:

> "The general rules yield to a special rule if the debtor owes a duty to a third person to devote money furnished by the third party to the satisfaction of a particular debt, and the creditor knows *or has reason to know* that the debtor owes such a duty to a third person. In this situation the payment may not be applied to other debts." (Emphasis supplied.)

The petition on page 9 cites three cases which Petitioner asserts "reject the special rule used in *Farnsworth* and companion Federal cases." *F. H. McGraw & Co. v. Milcor Steel Co.* (2nd Cir. 1945), 149 F.2d 301, is the only one of these cases decided by a Federal court and this decision is an application of the law of the State of New York in a case involving a State of Connecticut public contract. The Court recognized that the New York rule it was obliged to follow in that case was contrary to the rule established by the Federal Courts of Appeal:

> "Under the contrary rule stated in such cases as *R. P. Farnsworth Co. v. Elec. Supply Co.*, 112 F.2d 150, * * *; *U. S. for Use of Crane Co. v. Johnson, et al.*, 67 F.2d 121; *Columbia Digger Co. v. Sparks*, 227 F. 780, the result might well be otherwise."

There are recent state court decisions in mechanics' lien cases which conform to the decision below and the federal decisions cited therein: *Barnett v. Concrete etc. Co.* (1960), 120 Fla. 628, 120 So.2d 628; *Wells v. Planters Lumber Co.* (1959), 230 Ark. 570, 327 S.W.2d 1.

Respondent does not concede that the analysis of the *Beck, Farnsworth* and *Johnson* cases as read by the Petitioner and set forth in the petition (pp. 5 and 6) is accurate or useful for the purposes presented in the petition for review.

In each of these cases a Court of Appeals held that a supplier of materials to a subcontractor of a government contrac-

tor was not entitled under the Miller Act to recover from the prime contractor, or the surety on his Miller Act bond, for his charges for these materials because he was obligated by law to credit against these charges sums he had received from the subcontractor which he had credited to other accounts with that subcontractor.

In each of these cases the Court recognized that the use plaintiff creditor was under legal duty to apply payments received from the subcontractor to the account covering materials furnished to the contract for which the prime contractor and his surety were liable when:

(a) The source of the funds was traceable directly to the prime contractor, or

(b) The use plaintiff creditor knew, or *had reason to know*,[1] or was *aware*[2] that the funds received were "the proceeds, or fruits of proceeds, of the very contract or transaction covered by the obligation of the surety."[3]

The essential principle of these decisions was not based on tracing identical funds, but upon an equitable duty, the application of which has no reasonable relation to dollar for dollar tracing of payments. Current deposits are the source of funds currently disbursed in a bank account.

---

[1] *U. S. for Use of Carroll v. Beck* (6th Cir. 1945), 151 F.2d 964:

"• • •• There is a limitation on the debtor's power to control application, and if he is under a duty to a third person to devote the money to discharge of a particular debt, and the creditor knows, or has reason to know of such duty, then the payment must be so applied."

[2] *Farnsworth & Co., Inc., v. Electrical Supply Co.* (5th Cir. 1940), 112 F.2d 150, cert. den. 311 U.S. 700, 85 L. ed. 454:

"Electric • • • got leave to inspect his books to keep check on him, and used the privilege, and was aware that the moneys paid were from this job although paid by Freeman's personal check."

Sec. 388, Vol. 2, *American Law Institute's Restatement of the Law of Contracts.*

[3] *U. S. for Use of Crane v. Johnson* (4th Cir. 1933), 67 F.2d 121.

It is submitted that the Court of Appeals decision is not in conflict with any other decision of another Court of Appeals; the Petitioner is in reality requesting this Court to analyze the detailed facts of this case and determine whether the Court of Appeals correctly applied established rules of other decisions to those facts.

2. The Court of Appeals Has Not Decided an Important Question of Federal Law; the Decision Below Would Have No Applicability to Claims of Laborers, and Would Be Applicable to Claims of Material Suppliers and Subcontractors Only in Unusual Situations.

It is asserted in the petition (p. 10) that factors which "weigh heavily in favor of granting a writ" include:

> "The impact that the opinion of the Court of Appeals will have on the protection provided subcontractors, laborers and materialmen under the Miller Act."

It is inconceivable that the decision of the Court of Appeals will have any impact on the protection provided by the Miller Act for laborers. Laborers and employees do not customarily furnish their services under terms of credit extending for periods in excess of nine months, nor enter into arrangements with their employers whereby they effectively control or participate in management of their employer, as was the situation in the case below.

A subcontractor of a subcontractor of a government prime contractor cannot assert a claim under the Miller Act. *Elmer v. U. S. Fidelity & Guaranty Co.*, 275 F.2d 89, 79 A.L.R.2d 883, cert. den. 363 U.S. 843, 4 L.ed. 2d 1727, 80 S.Ct. 1612. *MacEvoy Company v. United States for Use of Tomkins Company*, 322 U.S. 102, 88 L.ed. 1163. Consequently the decision has no impact on subcontractors unless they have a contract with the prime contractor, and are in such an economic position with respect to the prime contractor as to enable them to

establish a relationship of the character found below between the Petitioner and the subcontractor.

The Petitioner as Use-Plaintiff in the decision below was not simply in the position of a creditor receiving payments in the usual course of business; the Petitioner was in an unusual position to know the exact source of the funds and to direct the payments so as to determine which creditors of the subcontractor would be paid, and to inequitably exploit its own position under the Miller Act. Relatively few creditors would ever be in this position.

It is submitted, therefore, that the decision below does not have that degree of importance which ranks it in the area of decisions which this Court reviews on writ of certiorari.

3. The Decision Below Does Not Decide a Question of Federal Law Which Has Not Been But Should Be Settled by This Court.

One of the leading cases relied on by the Court of Appeals in the decision below was *Farnsworth & Co., Inc., v. Electrical Supply Co.* (5 Cir. 1940), 112 F.2d 150, 130 A.L.R. 192. This Court denied a petition of the Use-Plaintiff in that case for writ of certiorari, 311 U.S. 700, 85 L.ed. 454.

It is urged by the Petitioner in favor of granting a writ (Brief p. 10): "The continuing uncertainty as to the validity of the special rule of application of payment to guaranteed debts as reflected in both the Federal and State cases of the past fifty or more years."

Petitioner does not make clear in what respects there has been uncertainty.

Apparently, to avoid uncertainty, the Petitioner would have this Court consider whether a rule applied and established in decisions of the Court of Appeals of the United States in five circuits should be set aside or modified in favor of the views expressed by the Supreme Courts of Utah and

Minnesota in cases not involving the Miller Act or any federal statute.

It is submitted that nothing in the Petitioner's brief substantiates its assertion that this Court should concern itself with this case in order to alleviate "fifty years of continuing uncertainty in federal law." On the contrary, the problem has been competently dealt with by the Courts of Appeal.

The Court is invited by the Petitioner to adopt the theory of the Utah Court that no equities should be extended to surety companies under "modern day realities of the construction industry" (Petition page 9). The "realities" are illustrated and demonstrated only by reference to testimony of the president of Schroeder that "contractors must necessarily use specific contract monies for payment of other obligations such as payrolls and stock items" (Brief p. 9). It is difficult to understand what relevant "modern day realities" have developed within the past fifty years during which the challenged decisions of the Court of Appeals were being considered that did not confront a creditor with a customer in tight financial circumstances at any time in the past. The same construction business problem was found in *U. S. v. American Bonding & Trust Co.* (9 Cir. 1898), 89 Fed. 925, where the Court denied recovery to a supplier of lumber to a government contractor in an action on the contractor's bond, where it appeared that the supplier had received sums from the contractor in excess of the value of the materials furnished, but, with knowledge of the suretyship, applied the funds to other accounts with the contractor.

The doctrine of the Utah and Minnesota courts, if applied to Miller Act cases in which the facts are similar to those found in the decision below, would have the practical effect of providing a supplier with a tool, not only to collect directly from the prime contractor and his surety the obligations

due him from the subcontractor for materials furnished by the supplier to the government contractor, but also by extension of extraordinary credit to a captive customer while payments from the prime contractor are being channeled to older and other accounts, to indirectly collect from the prime contractor and surety other and older accounts, not related to the government contract, between the same supplier and subcontractor. It is submitted that although the Miller Act was designed to protect the suppliers of government subcontractors, there was *no intent that the Miller Act surety* should be exposed to liability for the entire state of accounts between a subcontractor and his supplier.

This Court, in referring to the remedial nature of the Miller Act, has said, "But such a salutary policy does not justify ignoring plain words of limitation and imposing wholesale liability on payment bonds." *Clifford E. MacEvoy Co. v. United States*, 322 U.S. 102, 107, 88 L.ed. 1163, 1167, 64 S.Ct. 890.

In *Farnsworth* the Court said:

> "What has happened allows Electric to collect its old debt out of the moneys paid on this contract, and to leave the charges for material furnished for it outstanding against the bond. This is to the prejudice of the principal and the surety on the bond, and of the other beneficiaries on the bond, and if sanctified might cause great injustice."

The foregoing statement of the Court of Appeals for the 5th Circuit indicates that broader policy considerations are involved in these cases than the comment of the dissenting judge, to which the Court is referred on pages 8 and 9 of the petition to the effect that the decision in *Columbia Digger* exhibited a "tender regard for the rights of sureties," and the point of view expressed by the Utah court that rules of suretyship should not apply to surety companies. These con-

siderations disregard and overlook the customary practice of indemnity agreements between government contractors and the sureties on their bonds which pass the ultimate liability to the contractor; the loss ratio-relation to premium cost on these bonds; and the fact that where bankruptcy occurs the aggregate of Miller Act claims may exceed the principal amount of the bond.

The ultimate result of the adoption of a policy contrary to the rule as applied in the decision below will be to enable suppliers to sell materials to subcontractors known by them to be in "shaky" financial condition on extraordinarily liberal credit; if the subcontractor thereafter becomes bankrupt, the supplier can recover the whole delinquent account from the prime contractor who may have no reason to know of the poor financial condition of the subcontractor and who, in reliance on an apparently sound financial condition, has made progress payments in due course of business on the same account. The government contractor is therefore subjected to a hazard of being obligated to pay twice for the same materials in those cases where the primary basis for the trouble is over-extension of credit by a large supplier to a captive customer. The eventual consequence of the policy urged must necessarily be an increased hazard to government contractors which will be reflected in increase in their clerical and accounting expense and bond premiums which will result in increased cost of construction to the United States.

It is submitted that these considerations illustrate that the well considered decision below and its companion cases in the Courts of Appeals establish no rule of law which is uncertain or outmoded, and the petition presents no question of federal law which should be settled by this Court.

4. The Decision Below Is Not in Conflict with State Law, and No Other Ground for Invocation of the Writ Is Presented by the Petitioner.

The Court of Appeals in the decision below noted that the rule it applied was in harmony with the statutory law of the State of North Dakota where the transactions took place (Petitioner's Appendix p. 14). The Miller Act cases, in any event, are governed by Federal law only. *Farnsworth & Co. v. Electrical Supply Co.* (5th Cir. 1940), 112 F.2d 150.

CONCLUSION

In conclusion, it is urged that the petition for writ of certiorari be denied.

Respectfully submitted,

BENEDICT DEINARD
512 Nicollet Building
Minneapolis 2, Minnesota
Attorney for Respondent

EDMUND T. MONTGOMERY
RICHARDS, MONTGOMERY, COBB & BASSFORD
1430 Rand Tower
Minneapolis 2, Minnesota
Of Counsel